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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 63

STEELE'S MILLS, A CORPORATION, AND WACHOVIA BANK & TRUST COMPANY, AS TRUSTEE, PETITIONERS

v.

CHARLES H. ROBERTSON, COLLECTOR OF INTERNAL REVENUE FOR THE COLLECTION DISTRICT OF NORTH CAROLINA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 25) is not reported. The opinion of the Court of Appeals (R. 60–69) is reported at 172 F. 2d 817.

JURISDICTION

The judgment of the Court of Appeals was entered February 11, 1949. (R. 69.) The petition for a writ of certiorari was filed May 4, 1949.

The jurisdiction of this Court rests upon 28 U. S. C., Section 1254.[1]

QUESTION PRESENTED

Whether a trust fund created by taxpayer-employer in the taxable year 1941, distributable in future years in consideration of future services of its employees, represented a current operating expense of taxpayer's business deductible from its 1941 gross income under Section 23 (a) (1) (A) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*, pp. 15–17.

STATEMENT

The facts found by the District Court (R. 20–24) may be summarized as follows:

The taxpayer corporation, a manufacturer of cotton textile products, maintains its plant in a remote North Carolina village whose 1,500 population consists of taxpayer's 500 employees and their families. (R. 20.) The scale of wages in the industry is comparatively low, and for many years prior to the taxable year (1941) it had been taxpayer's policy to aid its employees in financial

[1] By orders of this Court dated May 31, 1949, and July 19, 1949, the time for filing a response to the petition was extended to thirty days after the entry of judgment by the United States Court of Appeals for the Sixth Circuit in a second appeal pending in the case of *Lincoln Electric Co.* v. *Commissioner*. The second appeal in that case was decided August 29, 1949.

emergencies by extending credit at the company store and for medical and hospital expenses, a policy which built employee good will and reduced labor turnover. The credits thus extended to the employees were collected through payroll deductions. After adoption of the National Labor Relations Act, which prevented collection of employee accounts through payroll deductions, this practice was discontinued. (R. 20–21.)

On December 30, 1941, taxpayer executed a trust agreement and on the same day turned over to the trustee bank $28,610 in cash and bonds. (R. 22.) The trust agreement (R. 1–9), which is incorporated by reference in the District Court's findings (R. 22), stated that its purpose was the "furtherance and strengthening of the loyalty and good will" of taxpayer's employees (R. 2). It provided that the trust fund was to be used in the discretion of a committee to make loans (not exceeding $100) at 6% interest to employees who needed financial assistance in case of illness or accident and who had been in taxpayer's employ at least one year preceding their request for benefits, or to their dependents; the committee in its discretion could convert any loan into a "donation." (R. 4–5.) Any employee who left taxpayer's employ was to "forfeit" all benefits in the fund. (R. 4.) Collections of loans were to be made through taxpayer's payroll. (R. 5–6.) Expenditures of the trust fund were not to exceed

in any one year the trust income for that year plus 5% of the original principal, except with taxpayer's written approval; at no time were loans to employees to exceed 20% of the original principal; and no expenditure (except for administration expenses) could be made within one year of the creation of the trust, except in an emergency declared by the committee. (R. 6.) The trust was to continue for twenty years, and taxpayer could terminate it sooner by notice to the trustee or extend the term by amendment. At the termination of the trust the fund then on hand was to be distributed to such of taxpayer's employees who "shall have had at least five years continuous service with the Grantor [taxpayer] immediately preceding the termination of the trust," and whom the committee considered most deserving on the basis of services and prior wages. (R. 8.) Taxpayer reserved the right at any time to amend the trust instrument, except to revert in itself any of the trust fund (R. 8–9), and the right at any time upon written notice to remove the trustee, or any member of the committee, and to appoint successors (R. 7, 8). It also reserved the privilege, but did not obligate itself, to increase the trust fund. (R. 2.)

The wages paid by taxpayer in 1941 totaled about $437,000, or an average of about $875 for each of its 500 employees. The trust fund represented slightly more than 6% of taxpayer's total

labor cost for the year, and about 5% of its net profits before income taxes. (R. 22.)

In its 1941 tax return taxpayer deducted the entire amount of the trust fund from its gross income for that year. (R. 23.) After the Commissioner disallowed the deduction, the trust agreement was amended by an instrument executed December 10, 1943 (R. 10–15), which is incorporated by reference in the District Court's findings (R. 23). This amendment provided that the trust was to defray any taxes due from taxpayer by reason of the Commissioner's disallowance of the claimed deduction, as well as the costs incurred by taxpayer in seeking recovery of the taxes paid. (R. 12, 13.) In 1944 taxpayer paid the deficiency ($22,257) by check of the trustee payable to it and endorsed to the Collector. (R. 23.) Thereafter it duly filed a claim for refund, which was denied, and instituted suit for refund in the District Court below. (R. 24.) Proceedings were subsequently instituted by taxpayer in the North Carolina Superior Court for a declaratory judgment as to the validity and construction of the trust; that court declared the trust valid and interpreted its provisions broadly, and its decree was affirmed by the North Carolina Supreme Court with certain modifications. (R. 24, 40–43.)

In addition to the above findings, the uncontradicted testimony of taxpayer's president shows that (1) the trust has never functioned in any

way, and up to the date of the trial "no employee has obtained any benefits whatever from it" (R. 17, 19–20); (2) taxpayer's purpose in creating the trust was to "provide in prosperous years for lean years" (R. 18–19); and (3) the suit for a declaratory judgment brought in the North Carolina court was not an adversary proceeding, but a "friendly" suit in which all the parties were "trying to get the same result" (R. 17, 19).

The District Court held that the trust fund was deductible from taxpayer's 1941 gross income under Section 23 (a) of the Internal Revenue Code as an ordinary and necessary expense of carrying on taxpayer's business in that year (R. 24), and granted judgment for taxpayer (R. 25–26). It did so on the theory that the disposition of this case was "controlled" as a matter of law by *Lincoln Electric Co.* v. *Commissioner,* 162 F. 2d 379 (C. A. 6th), rather than by *Roberts Filter Mfg. Co.* v. *Commissioner,* 10 T. C. 26, then pending on petition for review in the Court of Appeals for the Third Circuit. (R. 25.)[2] The Court of Appeals reversed, holding that the expenditure creating the trust fund was not a current operating expense of taxpayer's business falling within the purview of Section 23 (a), but was a capital outlay designed to benefit the business over a number of future years. (R. 60–69.)

[2] The Tax Court's decision in the *Roberts Filter* case was subsequently affirmed, 174 F. 2d 79.

ARGUMENT

There is no occasion for further review. The decision below is correct and does not present a conflict.

1. The only business expenses allowable as deductions under Code Section 23 (a) (Appendix, *infra*), for purposes of computing the net income for a given taxable year, are the ordinary and necessary expenses paid or incurred in carrying on the business during that year. Expenditures which yield economic benefits to the business over a number of years are non-deductible capital investments, not current operating expenses chargeable against the gross income of a single taxable year. This rule applies to expenditures which yield intangible benefits, as well as to those made to acquire tangible property.[3] Section 24 (a) (2) of the Internal Revenue Code (Appendix, *infra*); Section 19.21–1 (c) of Treasury Regulations 103 under the Code (Appendix, *infra*); *Welch* v. *Helvering,* 290 U. S. 111; *Houston Natural Gas Corp.* v. *Commissioner,* 90 F. 2d 814 (C. A. 4th), certiorari denied, 302 U. S. 722; *Clark Thread Co.* v. *Commissioner,* 100 F. 2d 257 (C. A. 3d); *Commissioner* v. *Boylston Market Ass'n.,* 131 F. 2d 966 (C. A. 1st); *Acer Realty Co.* v. *Commissioner,* 132 F. 2d 512 (C. A. 8th); *Baton Coal Co.* v. *Com-*

[3] The only deductions allowable on account of capital expenditures are for depreciation or depletion of business assets having a limited useful life. Code Section 23 (l) and (m).

missioner, 51 F. 2d 469 (C. A. 3d), certiorari denied, 284 U. S. 674; *Sunray Oil Co.* v. *Commissioner,* 147 F. 2d 962 (C. A. 10th); *Becker* v. *Evens & Howard Sewer Pipe Co.,* 70 F. 2d 596 (C. A. 8th); 4 Mertens, *Law of Federal Income Taxation,* Secs. 25.17–25.32.

The employees' trust fund which taxpayer here seeks to deduct from its 1941 gross income unquestionably represented an expenditure designed to benefit its business over a number of future years, not an expense of that year. The trust was to continue for twenty years, and by amendment taxpayer could extend its term indefinitely. (R. 8.) The fund was to be used in the discretion of a committee to make loans to employees who had been in taxpayer's employ at least one year preceding their request therefor, and the committee could convert any loan into a "donation." (R. 4–5.) Expenditures from the fund were not to exceed in any one year the trust income for that year plus 5% of the corpus, except with taxpayer's approval; and no part of the fund could be disbursed to any employee during the first year except in an emergency. (R. 6.) Any employee who left taxpayer's employ was to "forfeit" all benefits. (R. 4.) Upon termination of the trust, the fund on hand was to be distributed only among such of the employees who "shall have had at least five years continuous service with the Grantor immediately preceding the termination of the trust." (R. 8.) Significantly, up to the time of

the trial (1948) no part of the fund had yet been credited or disbursed to any employee. (R. 17, 19–20.) In substance the trust fund represented nothing more than a reserve set aside by taxpayer to pay additional compensation for services to be rendered by its employees in *future* years. Indeed, the avowed purpose of the trust was to strengthen the "loyalty and good will" of the employees (R. 2), and thereby induce them to remain in taxpayer's employ. Whether the fund be viewed as additional compensation or as some other class of business expense, it patently was not an expense of the taxable year falling within the purview of Section 23 (a). It was to be used to defray anticipated expenses of carrying on the business in later years. ***Roberts Filter Mfg. Co.*** v. ***Commissioner,*** 174 F. 2d 79 (C. A. 3d).[4]

It is fundamental that our federal system of taxation is based on an annual accounting of profits and losses. To permit a taxpayer to offset against its business income for a single taxable year an expenditure intended to benefit the business over a number of future years would violate

[4] As pointed out in the *Roberts Filter* case, *supra*, involving a similar issue, it is clear from the legislative history of Code Section 23 (p) (Appendix, *infra*), covering the deductibility of contributions to pension trusts, that Congress intended in Section 23 (a) to authorize the deduction of contributions to employees' trusts only to the extent that such contributions represented liabilities accruing during the taxable year (i. e., for current services) and were reasonable in amount.

this basic principle by distorting the net income for the taxable year. What is more, it would open the door wide to easy tax avoidance by taxpayers whose business earnings fluctuate widely from year to year; tax liability for a high-income year could be reduced, or even extinguished, simply by carving out of the taxable income for that year a trust fund which is to be used to meet the expenses of future low-income years. This case presents a striking example of the use of the trust device for the purpose of minimizing tax liability. The trust was created on December 30 of a year in which the taxpayer was in approximately the 90% bracket for excess-profits tax purposes (R. 18), and taxpayer's president acknowledged that it was created in order to "provide in prosperous years for lean years" (R. 19). That tax saving was a dominant motivating factor is evident from the fact that, after the Commissioner disallowed the claimed deduction, the trust agreement was amended to provide that the trust fund be used to pay the resulting deficiency and the cost of litigating it (R. 10–15), and that practically the entire fund was in fact used to defray taxpayer's tax liability (R. 23).

2. Taxpayer relies chiefly (Pet. 5, Br. 12–13) upon an asserted conflict with *Lincoln Electric Co.* v. *Commissioner,* 162 F. 2d 379 (C. A. 6th), which the District Court below deemed dispositive of this case as a matter of law (R. 25). But that case was remanded for further proceedings,

and an appeal by the Commissioner from the Tax Court's decision on the remand was pending at the time the petition for certiorari herein was filed. On this second appeal, recently decided (August 29, 1949, C. C. H., par. 9388), the Court of Appeals reversed the Tax Court's decision on the remand, and held that the Tax Court had misconstrued its prior opinion by considering itself required as a matter of law to allow the claimed deductions. It again remanded the case to the Tax Court, with directions to determine the reasonableness of the amounts claimed. In rejecting the taxpayer's contention that its prior opinion required allowance of the claimed deductions, the court stated that "As a matter of strict interpretation of our ruling, the taxpayer is incorrect in stating that we held the payments to be ordinary and necessary expenses and deductible in full."

The decision on the second appeal in the *Lincoln Electric* case dispels the conflict asserted by taxpayer. In that case some portions of the claimed deductions might by further proof be shown to constitute expenses of the taxable years in which they were claimed,[5] and accordingly remand of the case for determination of the reasonable amounts deductible in those years may have been appropriate. Here, on the other hand, no question of reasonableness of the amount de-

[5] Part of the payments involved in the *Lincoln Electric* case may have represented non-forfeitable benefits to employees in consideration of services already rendered.

ductible in the taxable year is reached, because no part of the amount could have represented an expense of that year; remand of the case to determine a reasonable amount allowable for that year would have been futile for, as is plain from the terms of the trust instrument itself, the instant fund was distributable in its entirety in consideration of future years' services. Any employee who did not remain in taxpayer's employ was to "forfeit" all right to share in the fund (R. 4), the trustees were enjoined from dispensing any of the fund during the first year of the trust (R. 6), and admittedly not a single dollar of it has yet vested in any employee (R. 17, 20). The court below recognized (R. 67) that an amount set aside in trust in one taxable year, bearing some "reasonable relation" to the operating expenses of that year, might qualify for deduction in that year. It properly refused, however, to assimilate such a situation to one where (as here) the fund is to be used solely to meet expenses yet to be incurred. *Roberts Filter Mfg. Co.* v. *Commissioner, supra.* Had this case come before the court which decided the *Lincoln Electric* case, there is no reason to suppose that a different result would have been reached.*

* After the preparation of this brief, the taxpayer in the *Lincoln Electric* case filed a petition for rehearing which the Court of Appeals for the Sixth Circuit has not yet acted upon. In the event that that court should grant the petition and substantially change its view of the case, the respondent may wish to reexamine its position in the instant case.

3. The importance which taxpayer ascribes to this case (Br. 13–14) has been minimized by amendments to Code Section 23 (p) and corollary Section 165 enacted by Section 162 of the Revenue Act of 1942, c. 619, 56 Stat. 798, applicable to taxable years after 1941. By these amendments Congress has dealt comprehensively with the deductibility by employers of payments to employees' trusts and under other deferred compensation plans. Section 23 (p) as amended provides that such payments to be deductible must satisfy the particular conditions there prescribed (in addition to the overall requirements of Section 23 (a)), and limits the amount deductible in any one taxable year.[1] The 1942 amendments

[1] The opening portion of Section 23 (p) as amended provides:

"(p) *Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan.*—

"(1) *General rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) [of Section 23] but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent: * * *"

Subparagraph (D) provides that contributions under plans not embraced by the preceding subparagraphs (which cover pension, retirement, stock bonus, and profit-sharing plans) are deductible only if the employees' rights "are nonforfeitable at the time the contribution or compensation is paid."

were designed to "safeguard the public against the use of the pension plan as a tax-avoidance device," and to treat "all methods of providing deferred compensation for employees" on a similar basis. H. Rep. No. 2333, 77th Cong., 2d Sess., p. 51 (1942–2 Cum. Bull. 372, 413). See also *Roberts Filter Mfg. Co.* v. *Commissioner, supra;* Section 29.93 (p)–1 of Treasury Regulations 111 under the Internal Revenue Code.

CONCLUSION

The decision below is correct, and there is no conflict. The petition for certiorari should be denied.

Respectfully submitted.

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SEPTEMBER, 1949.

APPENDIX

Internal Revenue Code:

SEC. 23 [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(p) *Pension Trusts.*—

(1) *General rule.*—An employer establishing or maintaining a pension trust to provide for the payment of reasonable pensions to his employees shall be allowed as a deduction (in addition to the contributions to such trust during the taxable year to cover the pension liability accruing during the year, allowed as a deduction under subsection (a) of this section) a reasonable amount transferred or paid into such trust

during the taxable year in excess of such contributions, but only if such amount (1) has not theretofore been allowable as a deduction, and (2) is apportioned in equal parts over a period of ten consecutive years beginning with the year in which the transfer or payment is made.

* * * * *

(3) *Exemption of trusts under section 165.*—The provisions of paragraphs (1) and (2) of this subsection shall be subject to the qualification that the deduction under either paragraph shall be allowable only with respect to a taxable year (whether the year of the transfer or payment or a subsequent year) of the employer ending within or with a taxable year of the trust with respect to which the trust is exempt from tax under section 165.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

* * * * *

(26 U. S. C. 1946 ed., Sec. 24.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.21–1. *Meaning of net income.*—

* * * * *

(c) Net income, meaning gross income less statutory deductions. The statutory

deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. (See sections 23 and 24.)

* * * * *

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